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IN THE SUPREME COURT OF THE UNITED STATES.

October Term, 1951.

No. .....

Standard Paving Company, a dissolved corporation, appearing through I. V. Gray, Chas. Gray, J. L. Gray, J. B. Gray, and H. C. Gray, its directors at the time of dissolution and its liquidating trustees,

Petitioners,

vs.

Commissioner of Internal Revenue, *Respondent.*

Standard Paving Company, a corporation, *Petitioner,*

vs.

Commissioner of Internal Revenue, *Respondent.*

PETITION FOR WRIT OF CERTIORARI.

To the Honorable Fred M. Vinson, Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Your petitioners, Standard Paving Company, a dissolved corporation, appearing through I. V. Gray, Chas. Gray, J. L. Gray, J. B. Gray, and H. C. Gray, its directors at the time of dissolution and its liquidating trustees, and Standard Paving Company, a corporation, respectfully jointly petition this Honorable Court for a writ of *certiorari* requiring the United States Court of Appeals for the Tenth Circuit to certify to this Court full and complete transcripts of the record and of the proceedings of said United

States Court of Appeals for the Tenth Circuit had in the cases of Standard Paving Company, a dissolved corporation, appearing through I. V. Gray, Chas. Gray, J. L. Gray, J. B. Gray, and H. C. Gray, its directors at the time of dissolution and its liquidating trustees, *vs.* Commissioner of Internal Revenue, No. 4145 on its docket, and Standard Paving Company, a corporation, *vs.* Commissioner of Internal Revenue, No. 4146 on its docket, to the end that said cases may be reviewed and determined by this Court as provided for by the statutes of the United States.

Statement of Matter Involved.

The controversy involves the proper determination of the liability of Standard Paving Company, a dissolved Oklahoma corporation (hereinafter referred to as "Oklahoma Standard"), for Federal declared value excess-profits tax and excess profits tax for the taxable period January 1, 1942, to September 20, 1942.

The petitioners in *Standard Paving Company, a dissolved corporation,* v. *Commissioner of Internal Revenue* were the directors of Oklahoma Standard and by virtue of the statutes of the State of Oklahoma became its trustees for the purpose of winding up its affairs. That case involves the tax liability of Oklahoma Standard. The case of *Standard Paving Company, a corporation,* v. *Commissioner of Internal Revenue* involves the transferee liability of Standard Paving Company, a Delaware corporation (hereinafter referred to as "Delaware Standard"), the successor in interest to Oklahoma Standard. The liability of the transferee for all taxes due from Oklahoma Standard is conceded (R. 71, 72) and therefore the issues in each case are identical. Accordingly, the petitioners in each case join

in this Petition for Writ of Certiorari. (Supreme Court Rule 48.)

Oklahoma Standard was organized in 1921, and engaged in the general contracting business constructing roads, streets, bridges, dams, airports and other public works (R. 74). All of its stock was owned by Delaware Standard until September 20, 1942, the date of the tax-free liquidation of Oklahoma Standard (R. 44, 45, 74). Both corporations on their books of account and in their tax returns always reported income from construction contracts on the completed contract method, and, therefore, always deferred all income and expense on incomplete contracts until the contracts had been completed (R. 75, 137, 189, 190). This method, widely used by public works contractors and the most practical way to determine profit or loss from construction contracts (R. 138, 191, 230), had never been questioned by the Commissioner of Internal Revenue prior to the determination of the deficiencies in tax of Oklahoma Standard for the period ending September 20, 1942. (R. 75)

On February 18, 1942, Oklahoma Standard and two other contractors by written agreement formed a joint venture (hereinafter referred to as the "Gruber joint venture") for the purpose of performing construction work at Camp Gruber, Oklahoma (R. 75). On March 2, 1942, the Gruber joint venture entered into a subcontract with the prime contractor to construct a portion of the camp (R. 75). On August 15, 1942, the Gruber joint venture entered into a contract with the United States of America for the construction of certain access roads near Camp Gruber (R. 75).

On May 20, 1942, Oklahoma Standard and two other contractors, acting as joint venturers, entered into a con-

tract with the United States of America for the construction as the prime contractor of an airfield near Dalhart, Texas (R. 76). The following day Oklahoma Standard and the two other contractors by written agreement formed a joint venture (hereinafter referred to as the "Dalhart joint venture") for the purpose of constructing the airfield (R. 76).

On April 7, 1942, Oklahoma Standard entered into a contract (hereinafter referred to as the "Memorial Boulevard contract") with the State Highway Commission of the State of Oklahoma for the construction of certain roads near Tulsa, Oklahoma (R. 76).

The Gruber subcontract, the Gruber access roads contract, the Dalhart contract and the Memorial Boulevard contract each provided that partial payments for work performed were to be made from time to time as work progressed, and that ten per cent of each partial payment would be retained by the Government until final completion and acceptance of all work covered by the contract (R. 75, 76, 77, 83). These retained amounts will be referred to hereinafter as "retainage." Each contract also provided for payment of liquidated damages in the event of failure of the contractor to complete its work on time (R. 75, 76).

As of the close of September 20, 1942, Oklahoma Standard was liquidated completely in a tax-free reorganization under Section 112(b) (6) of the Internal Revenue Code by transfer of all of its assets, subject to its liabilities, to its sole stockholder, Delaware Standard (R. 8, 9, 78). Delaware Standard expressly agreed as a part of the reorganization to perform all of the uncompleted contracts of Oklahoma Standard, and after September 20, 1942, did complete all such contracts (R. 78).

On September 20, 1942, the two Gruber contracts, the Dalhart contract and the Memorial Boulevard contract, were all incomplete (R. 79, 81, 83). On September 20, 1942, retainage in the total amount of $101,416.70 was being withheld from Oklahoma Standard with respect to the several contracts (R. 79, 81, 83). On that date there was withheld from the Gruber joint venture $6,300.00 in liquidated damages (R. 79) and on September 29, 1942, they were increased by $2,700.00. Oklahoma Standard's portion thereof was one-third. On December 7, 1942, all liquidated damages were cancelled. The Dalhart joint venture had not been assessed any liquidated damages at September 20, 1942, but on November 17, 1942, it was assessed $15,500.00 of liquidated damages, which were cancelled on December 26, 1942.

After September 20, 1942, the construction contracts of the Gruber joint venture were amended several times to extend by 42 days the time for completing the contracts and to increase the contract prices by $347,185.52 (R. 79). Oklahoma Standard's portion thereof was one-third. After September 20, 1942, the Dalhart contract was amended several times to extend the time for completing the contract and to increase Oklahoma Standard's portion of the contract price by $22,481.19 (R. 81). No portion of the contract increases could be paid until the amendments had been executed by the parties thereto (R. 79, 81).

The total cost of the two contracts of the Gruber joint venture was $2,229,721.76, of which $1,955,586.55 was incurred by September 20, 1942 (R. 79). The Gruber joint venture by that date had received $2,209,845.96 as partial payment for work done under the contracts (R. 76, 79).

The total net cost of Oklahoma Standard's portion of the Dalhart contract was $515,760.20 of which $442,251.98 was incurred by September 20, 1942 (R. 81). Oklahoma Standard by that date had received $256,735.16 as partial payment for work done under the contract and had earned an additional $208,463.31 for such work (R. 81).

On September 20, 1942, Oklahoma Standard had incurred $77,576.35 of cost with respect to the Memorial Boulevard Contract and by that date had received $81,249.37 as partial payments for work done under the contract (R. 83).

The contracts of both the Gruber joint venture and the Dalhart joint venture were renegotiated in August and June, 1943 (R. 80, 82). For Federal tax purposes, both joint ventures were on the calendar year basis of accounting (R. 80, 82).

The work performed on each construction contract was finally accepted and approved on the following dates:

Gruber joint venture
subcontract—May 10, 1943 (R. 79-80)
access roads—December 3, 1942 (R. 76)

Dalhart joint venture—December 11, 1942 (R. 82, 181-182)

Memorial Boulevard contract—November 3, 1943 (R. 83).

Oklahoma Standard did not report any income from the Gruber or Dalhart joint ventures in its tax returns for the period ended September 20, 1942 (R. 80, 82). Delaware Standard in its tax returns for the fiscal year ended September 30, 1943, reported net income of $29,528.50 (R. 80), including therein the net profits from the Gruber and Dal-

hart contracts. Oklahoma Standard did report $12,700.72 of profit from the Memorial Boulevard contract in its tax returns for the period ended September 20, 1942, upon the mistaken assumption that the contract had been completed prior to September 20, 1942 (R. 83).

The Commissioner of Internal Revenue in his determination of the deficiencies of tax of Oklahoma Standard determined that the Gruber contracts had been entirely completed on September 20, 1942, and hence included the net profits therefrom in Oklahoma Standard's income for the period ending September 20, 1942. He further determined that the Dalhart contract was 95% complete on September 20, 1942, and applied that percentage to an estimated net profit, based on book costs at September 20, 1942 (R. 26-27). He made no adjustment with respect to the Memorial Boulevard contract (R. 96).

On petitions for redetermination of the deficiencies, The Tax Court of the United States held that on the facts presented, the completed contract method of accounting did not clearly reflect income and that therefore the Commissioner of Internal Revenue was authorized, under Section 41 of the Internal Revenue Code, to change Oklahoma Standard's method of accounting. In so ruling, The Tax Court held that Section 112(b) (6) of the Internal Revenue Code was not controlling and the fact that Oklahoma Standard was liquidated in a tax-free reorganization under Section 112(b) (6) did not bar application of Section 41. It further held that, although the Gruber and Dalhart joint ventures were on the calendar year basis of accounting (and hence the members thereof would not have realized any income prior to December 31, 1942), the transfer of Oklahoma Standard's interest in the joint ventures to Delaware

Standard caused the termination and dissolution of the joint ventures on September 20, 1942, requiring Oklahoma Standard, as a member thereof, to include in income on that date its share of the profits of each joint venture.

In determining the amount of income realized by Oklahoma Standard for the taxable period ending September 20, 1942, The Tax Court found that all the contracts were incomplete at the close of September 20, 1942, the percentage of completion of each on that date being as follows:

Dalhart	76.66%
Gruber	91.34%
Memorial Boulevard	98.67%

(R. 83). These percentages were multiplied by the actual ultimate net profit on each contract (R. 96, 101), resulting in a holding by The Tax Court that Oklahoma Standard for the taxable period ended September 20, 1942, realized taxable income in the following amounts:

From the Gruber joint venture	$208,998.11
From the Dalhart joint venture	90,293.19
From the Memorial Boulevard contract	12,531.80

(R. 101). In applying the percentages of completion to the actual ultimate net profits from the contracts, The Tax Court necessarily took into account amounts dependent on subsequent events and affecting the actual ultimate net profits, such as retainage, liquidated damages, increases in contract prices resulting from contract amendments after September 20, 1942, and renegotiation adjustments. Although these amounts could not be foreseen nor ascertained at September 20, 1942, The Tax Court decided that they should be included in applying the method of allocation used by The Tax Court in determining the portion of profits taxable to Oklahoma Standard.

Finally, The Tax Court held that a net operating loss (which resulted from shifting the income from Delaware Standard for the year ended September 30, 1943, to Oklahoma Standard for the period ending September 20, 1942) was not deductible by Oklahoma Standard as a net operating loss carry-back under Sections 23(s) and 122 of the Internal Revenue Code. The Tax Court opinion appears at pages 73 to 106 of the record and is officially reported in 13 T. C. 425.

On February 16, 1950, The Tax Court entered its decision ordering and deciding that there were deficiencies in Oklahoma Standard's declared value excess-profits tax and excess profits tax for the taxable year January 1, 1942, to September 20, 1942, in the respective amounts of $26,438.11 and $179,829.89 (R. 106). On petitions for review, the United States Court of Appeals for the Tenth Circuit, by opinion and judgments entered June 26, 1951, affirmed the decision of The Tax Court (R. 233-239).

Jurisdictional Statement.

The judgments of the United States Court of Appeals for the Tenth Circuit were entered June 26, 1951 (R. 238-239). The jurisdiction of this Court is invoked under Section 1254 (1) of Title 28 of the United States Code. Important questions of Federal taxation are involved.

Questions Presented.

The primary question presented by this controversy is whether Oklahoma Standard, which always reported income from construction contracts on the completed contract basis and which was completely liquidated in a tax-free reorganization as of the close of September 20, 1942, realized in-

come on that date from four construction contracts which then were incomplete.

If it be determined that Oklahoma Standard did realize income on that date from such contracts, the question then posed is the amount of such income on that date. In solving that question it becomes necessary to decide whether, in the application of Section 41 of the Internal Revenue Code, amounts, which under no method of accounting are accruable, could be included in the income of Oklahoma Standard on that date.

Reasons Relied Upon for Allowance of Writ.

1. The decision of the Court of Appeals that Section 41 of the Internal Revenue Code may be applied in a case where a corporation is liquidated in a tax-free reorganization under Section 112(b) (6) of the Internal Revenue Code involves an important question of Federal tax law which has not been, but should be, settled by this Court, and such decision is in conflict with the decision of the Court of Appeals for the Seventh Circuit in the case of *Advance Aluminum Castings Corp.* v. *Harrison,* 158 F. (2d) 922 (1946).

2. The decision of the Court of Appeals, in holding that the assignment and transfer of incompleted construction contracts requires the inclusion of a portion of the profits from said contracts in the income of the transferor, is in conflict with the decision of the Court of Appeals for the Eighth Circuit, on the same matter, in the case of *Iowa Bridge Co.* v. *Commissioner,* 39 F. (2d) 777 (1930).

3. The decision of the Court of Appeals, in holding that the assignor is taxable at the date of assignment on income earned but unpaid rather than at the time when the income is received by the assignee, is a decision of a Fed-

eral question in a way probably in conflict with the applicable decisions of this Court and is a decision in conflict with the decision of the Court of Appeals for the Fifth Circuit in the case of *Commissioner* v. *First State Bank of Stratford,* 168 F. (2d) 1004, 1010 (1948), cert. den., 335 U. S. 867 (1948).

4. The decision of the Court of Appeals, in affirming the holding of The Tax Court that the transfer of an interest in a joint venture requires the taxation as ordinary income to the transferor of its share of amounts theretofore earned by the joint venture, is in conflict with the decision of the Seventh Circuit in the case of *Swiren* v. *Commissioner,* 183 F. (2d) 656 (1950) cert. den., 340 U. S. 912 (1951), and with the decision of the Court of Appeals for the Third Circuit in the case of *Rogers* v. *Commissioner,* 180 F. (2d) 720 (1950).

5. The decision of the Court of Appeals, in affirming the holding of The Tax Court that the transfer of an interest in a joint venture terminates the joint venture, is a decision on an important question of local law in a way probably in conflict with applicable local decisions.

6. The decision of the Court of Appeals, in affirming the holding of The Tax Court that Section 41 of the Internal Revenue Code permits a member of a joint venture to be taxed prior to the end of the joint venture's accounting period on income earned by the joint venture, is a decision in conflict with Sections 182 and 188 of the Internal Revenue Code and with the decision of the Court of Appeals for the Sixth Circuit in the case of *Shunk* v. *Commissioner,* 173 F. (2d) 747 (1949).

7. The decision of the Court of Appeals, in approving the method used by The Tax Court in determining the

amount of income realized by Oklahoma Standard from the various contracts (which method differed from the method used by the Commissioner of Internal Revenue in his notice of deficiency), is in conflict with the decision of the Court of Appeals for the First Circuit in the case of *Ross* v. *Commissioner,* 169 F. (2d) 483 (1948).

8. The decision of the Court of Appeals, in holding that Section 41 of the Internal Revenue Code authorizes the inclusion in income on the date of the tax-free reorganization of items such as retainage, liquidated damages and contract increases (which as a matter of law are not then accruable), is a decision on a federal question in a way probably in conflict with the applicable decisions of this Court and is a decision in conflict with the decision of the Court of Appeals for the Third Circuit in the case of *Keasbey & Mattison Co.* v. *United States,* 141 F. (2d) 163, 166 (1944), and with the decision of the Court of Appeals for the Fourth Circuit in the case of *Clifton Mfg. Co.* v. *Commissioner,* 137 F. (2d) 290, 293 (1943), and with the decision of the Court of Appeals for the Eighth Circuit in the case of *Commissioner* v. *Mnookin's Estate,* 184 F. (2d) 89, 93 (1950).

9. The decision of the Court of Appeals, in holding that a net operating loss sustained by a successor parent corporation cannot be carried back through a tax-free reorganization and be deducted in the preceding year by the liquidated subsidiary under Sections 23(s) and 122 of the Internal Revenue Code involves an important question of federal tax law which has not, but should be, decided by this Court and is a decision in conflict with the decision of

the Court of Appeals for the Second Circuit in the case of *Stanton Brewery* v. *Commissioner*, 176 F. (2d) 573 (1949).

Respectfully submitted,

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BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Opinions of Courts Below.

The opinion of The Tax Court of the United States is reported in 13 T. C. 425 and is also printed in full in the record (R. 73-106).

The opinion of the United States Court of Appeals for the Tenth Circuit has not been officially reported but is printed in full in the record (R. 233-238).

Jurisdiction of This Court.

The jurisdiction of this Court is invoked under Section 1254 (1) of Title 28 of the United States Code.

The judgments of the United States Court of Appeals for the Tenth Circuit were entered June 26, 1951 (R. 238-239).

Statement of the Case.

A concise statement of the case containing all that is material to the consideration of the questions presented has been made in the Petition for Writ of Certiorari, which in the interest of brevity is not repeated here.

Specification of Assigned Errors.

The errors of the United States Court of Appeals for the Tenth Circuit intended to be urged are set out in the Petition for Writ of Certiorari under the heading, "Reasons Relied Upon for Allowance of Writ," and are adopted by reference as a part of this brief.

ARGUMENT.

Each of the points hereinafter set out is directed to the correspondingly numbered paragraph of the section of the Petition for Writ of Certiorari entitled, "Reasons Relied Upon for Allowance of Writ."

1.

A tax-free reorganization under Section 112 (b) (6) of the Internal Revenue Code cannot create taxable income which otherwise does not exist, and Section 41 of the Internal Revenue Code cannot be applied to destroy the benefits and consequences granted by Section 112 (b) (6).

This case represents the first attempt by the Commissioner of Internal Revenue to apply Section 41 of the Internal Revenue Code as a device whereby a subsidiary liquidated in a tax-free reorganization under Section 112 (b) (6) of the Code may be required to include in income amounts which, had it not been for the liquidation, would not have been includible in income at the time of the tax-free liquidation.

Had Oklahoma Standard not been reorganized it would not have realized any income at the close of September 20, 1942, from any of the construction contracts, as those contracts were all incomplete on that date. How, then, may the tax-free reorganization (resulting in no change in individual stockholder interest) create income which otherwise admittedly does not exist? Congress, by enactment of Section 112 (b) (6), has seen fit to provide that in cases where changes in corporate organization are essentially changes only in form, no gain or loss is to be recognized on the transfer in liquidation of the assets of the subsidiary to the

parent corporation. The Commissioner of Internal Revenue, realizing that the reorganization herein fully complied with the statute and was motivated by sound business purposes without thought of tax avoidance, asserted a right to apply Section 41 of the Code to change Oklahoma Standard's method of accounting and in so doing circumvented and destroyed the benefits which Congress has seen fit to grant under the tax-free reorganization sections. The Court of Appeals, in holding that Section 41 may be applied where a tax-free reorganization has occurred, has armed the Commissioner with a precedent which he may use to upset numerous corporate reorganizations which otherwise are regarded as tax-free. Such unlimited discretion in the Commissioner would permit him to determine whether allocating profits to the liquidating subsidiary or to the acquiring parent corporation would produce the most tax. Having once made such a determination, he could then utilize Section 41 by changing the accounting method of either or both corporations from a cash to accrual system, or from accrual to cash, or, if neither of such methods suited his purpose, he could impose some hybrid form of his own choosing which would elicit the greatest amount of tax. Whether Section 41 may be applied where there has been merely a tax-free reorganization, without more, is a question of great importance to business and industry and one which should be decided by this Court.

Further, the holding of the Court of Appeals that Section 112 (b) (6) does not bar application of Section 41 cannot be reconciled with the holding of the Court of Appeals for the Seventh Circuit in the case of *Advance Aluminum Castings Corp.* v. *Harrison,* 158 F. (2d) 922 (1946). Sections 41 through 45 contain the accounting provisions of the Internal Revenue Code. In the *Advance* case, Pattern,

a wholly owned subsidiary of Castings, was engaged in the sale of products on the installment contract plan and had elected to file its income tax returns on the installment sales accounting method provided for in Section 44 of the Code. On September 26, 1936, Pattern was liquidated completely under Section 112 (b) (6) and all of its assets and liabilities (including the installment sales contracts) were transferred to its parent, Castings. Pattern included in income only those installment sales collections it had received prior to the reorganization, while Castings reported as income the amounts (including profits) collected after the reorganization on the sales made by Pattern prior to the Section 112 (b) (6) liquidation. The Commissioner of Internal Revenue attempted to tax to Pattern a portion of the collections received by Castings after the date of the reorganization. The court held that, because of Section 112 (b) (6), Section 44 could not be applied to tax Pattern with collections received after the reorganization.[1]

2.

The decision of the Court of Appeals that the assignment and transfer of incompleted construction contracts requires the inclusion of a portion of the profits from said contracts in the income of the transferor is in conflict with the decision of the Court of Appeals for the Eighth Circuit in the case of *Iowa Bridge Co.* v. *Commissioner*, 39 F. (2d) 777 (1930).

In *Iowa Bridge Co.* v. *Commissioner*, 39 F. (2d) 777 (C. A. 8th, 1939), rev'g 14 B. T. A. 1048 (1929, a corporation, on May 28, 1921, had a large number of construction contracts in varying stages of completion on which it was

1. The last sentence of Section 44 (d) of the Internal Revenue Code was not enacted until 1938, two years after the reorganization of Pattern.

engaged. On that date it assigned and transferred to the owner of all but two shares of its outstanding stock the incomplete contracts, and the assignee thereafter completed the contracts. The assignee, in his individual return, "duly accounted for and paid tax at the current rates upon all the income derived from the contracts so sold, transferred, and assigned to him" (39 F. (2d) at 799). The court held that none of the income from the contracts was income to the assignor corporation.

The decision of the Court of Appeals for the Tenth Circuit in the instant case, involving almost identical facts, is wholly in conflict with the decision of the Court of Appeals for the Eighth Circuit in the *Iowa Bridge* case, and *certiorari* should be granted in order that this Court may resolve such conflict between the two Circuits.

3.

An assignor of income is not taxable on income earned but unpaid at the date of assignment until such time as the income is received by the assignee.

The Court of Appeals herein held that Oklahoma Standard realized income from the Dalhart and Gruber and Memorial Boulevard contracts on September 20, 1942, by reason of the transfer of the contracts on that date and that, since Oklahoma Standard had earned a portion of the income, it should be taxed thereon. However, the portions of profits taxed to Oklahoma Standard were not ascertainable and were not accrued or received by the assignee until after September 20, 1942.

In *Helvering* v. *Eubank,* 311 U. S. 122 (1940), this Court held that, where an insurance agent assigned renewal commissions to become payable to him for services which had been rendered by him in writing policies, the commissions

were taxable as income of the assignor in the year when paid to the assignees. See also *Helvering* v. *Horst*, 311 U. S. 112, 116. In the instant case, the Court of Appeals, although citing and relying on the *Eubank* and *Horst* decisions, has taxed the income to the assignor in the taxable period of the assignment, and not in the period in which the income was received by the assignee. If Oklahoma Standard is to be taxed at all on the profits derived from the construction contracts assigned, it is taxable only in the period when the contracts were completed and the income therefrom became fixed and determinable. The transfer is not the taxable event and the Court of Appeals' decision to that effect is in conflict with the decisions of this Court in the *Eubank* and *Horst* cases.

Furthermore, the instant decision is in conflict with the decision of the Court of Appeals for the Fifth Circuit in the case of *Commissioner* v. *First State Bank of Stratford*, 168 F. (2d) 1004 (1948), cert. den. 335 U. S. 867 (1948). There the question of anticipatory assignment of income was involved, the taxpayer having declared a dividend in kind of notes receivable. The court held that income was realized by the assignor not when the assignment was made but instead when the income was received by the shareholder-assignees on payment of the notes.

4.

An interest in a joint venture is a capital asset and a transfer thereof is a capital transaction. Income theretofore earned by the joint venture cannot be taxed as ordinary income of the member of the joint venture transferring his interest.

The Gruber and Dalhart contracts were being performed by two joint ventures, in each of which Oklahoma

Standard was a member. In the liquidation, Oklahoma Standard transferred its interest in the Gruber and Dalhart joint ventures to its parent, Delaware Standard. The Court of Appeals, in taxing to Oklahoma Standard as ordinary income its portion of income earned by the joint ventures prior to the transfer, has entered a decision directly in conflict with the recent decision of the Court of Appeals for the Seventh Circuit in the case of *Swiren* v. *Commissioner,* 183 F. (2d) 656 (1950), cert. den. 340 U. S. 912 (1951) wherein it was held that a transfer of an interest in a partnership is a capital transaction taxable only as a capital gain, even though the transfer included an interest in fees theretofore earned (both billed and unbilled) but uncollected, and that therefore the transferor was not in receipt of ordinary income. See also *Rogers* v. *Commissioner,* 180 F. (2d) 720 (C. A. 3d, 1950). Applying that holding here, none of Oklahoma Standard's interest in the profits of the Gruber and Dalhart joint ventures was taxable to it as ordinary income by reason of the transfers thereof. By virtue of the provisions of Section 112 (b) (6), any capital gain on the transfer was not recognizable.

Review by this Court should be had to resolve the conflict among the Circuits as to whether a transfer of an interest in a joint venture or partnership permits taxing to the transferor, as ordinary income, his portion of amounts theretofore earned but uncollected by the venture or partnership.

5.

A transfer of an interest in a joint venture does not terminate the joint venture.

The Tax Court of the United States recognized that, in order to tax to Oklahoma Standard on September 20,

1942, any portion of the profits derived from the construction contracts entered into by the joint ventures, there would have to be a finding that the joint ventures were terminated on that date, and therefore concluded that as a matter of law the transfer of Oklahoma Standard's interests in the ventures caused a dissolution of the ventures. The decision of the Court of Appeals, in affirming The Tax Court on this holding, is a decision clearly in conflict with governing local law.

It is established that a joint venture continues until the enterprise undertaken is completed and that a transfer of interest by one joint venturer to a third person does not terminate the joint enterprise. 30 American Jurisprudence, p. 703, at par. 48; 48 Corpus Juris Secundum, at p. 821. The Supreme Court of the State of Oklahoma has ruled that a joint venture does not terminate by reason of a transfer of a member's interest. *Ferguson* v. *Nagle,* 159 Okl. 219, 15 P. (2d) 1 (1932). Nor does a voluntary dissolution of a corporation terminate a joint venture to which it is a party. *Wyoming-Indian Oil and Gas Co.* v. *Weston,* 43 Wyo. 526, 7 P. (2d) 206, 80 A. L. R. 1037 (1932).

The Tax Court disregarded the law of joint ventures and applied the Oklahoma law governing partnerships, relying on an asserted rule that the law governing partnerships governs joint ventures. However, it is established in Oklahoma that the law governing partnerships does not necessarily apply to joint ventures. *Wertzberger* v. *McJunkin,* 171 Okl. 528, 43 P. (2d) 729 (1935). Indeed, continuity of a joint venture even though a member transfers his interest is one of the distinguishing characteristics of a joint venture. The Tax Court sought further justification for applying the law of partnerships by relying on Section

3797 (a) (2) of the Internal Revenue Code which defines partnerships to include joint ventures and then reasoned that, since partnerships and joint ventures are taxed alike, they are, in a tax controversy, to be treated exactly alike for all purposes. Such holding is a complete misinterpretation of the decision of this Court in *Burnet* v. *Harmel,* 287 U. S. 103 (1932), which held that state law "creates legal interests," the Federal tax laws merely determining how such legal interests shall be taxed once established and in existence.

The affirmance by the Court of Appeals of The Tax Court holding that under Oklahoma law the transfer of the interests in the joint ventures terminated the ventures is a decision on an important question of local law in a way directly in conflict with the applicable local decisions and such holding should be reviewed by this Court.

6.

Oklahoma Standard could not be taxed on any portion of the income from the Gruber and Dalhart contracts prior to December 31, 1942, the close of the accounting periods of the Gruber and Dalhart joint ventures.

A member of a joint venture does not realize any income from the joint venture prior to the end of the accounting period of the joint venture. Sections 182 and 188 of the Internal Revenue Code. This is true even though a member of a joint venture should receive an interim distribution from the venture. *Shunk* v. *Commissioner,* 173 F. (2d) 747 (C. A. 6th, 1949). Therefore, Oklahoma Standard could not be taxed at September 20, 1942, on income earned by either joint venture, even though Oklahoma Standard had received some interim distributions from the joint ventures,

for on September 20, 1942, the accounting periods of the joint ventures had not ended.

In this connection, it should be noted that Section 41 of the Internal Revenue Code could not be utilized to require Oklahoma Standard to accrue any portion of the profits of the joint ventures, for Section 188 of the Code directs that a member of a joint venture takes into income his share of the venture's profits on the date the accounting period of the joint venture ends, regardless of the method of accounting employed, whether proposed by the Commissioner or otherwise. The power of the Commissioner to utilize Section 41 to override the specific provision of Section 188 is an important question of Federal taxation which should be decided by this Court.

7.

Section 41 of the Internal Revenue Code authorizes only the Commissioner of Internal Revenue to change a taxpayer's method of accounting. The method of accounting used by The Tax Court and approved by the Court of Appeals differed from that proposed by the Commissioner.

The Commissioner of Internal Revenue in his formal notices of deficiency (which serve as the basis of jurisdiction in this proceeding) (R. 18-38, 49-70) took the position that the Gruber project had been completed prior to September 20, 1942 (R. 26-27, 80-81); and made no adjustment with respect to the Memorial Boulevard contract which Oklahoma Standard had erroneously reported as completed. It is apparent therefore that, with respect to those jobs, the Commissioner did not apply Section 41 to change accounting method but instead accepted Oklahoma Standard's completed contract method of accounting as correctly reflecting income. In his pleadings before The Tax Court the

Commissioner continued to take the position that the Gruber and Memorial Boulevard projects were completed prior to September 20, 1942 (R. 38-40).

With respect to the Dalhart contract, the Commissioner in his deficiency notice (R. 26-27) estimated the percentage of completion as of September 20, 1942, at 95%. He then estimated the profit which would be derived from the job, basing such estimate on the contract price less the estimated total cost (the estimate of total cost being based upon the book cost at September 20, 1942, as representing 95% of estimated total cost). The estimated profit was then multiplied by the estimated percentage of completion to arrive at the estimated profit at September 20, 1942, which the Commissioner deemed taxable to Oklahoma Standard on that date. He did not alter his position with respect to the Dalhart contract in his pleadings filed with The Tax Court.

The Tax Court, in determining the deficiencies, applied a single method to all three projects in ascertaining the income which it considered taxable to Oklahoma Standard for the period ending September 20, 1942. This method was neither the completed contract method nor the percentage of completion method used by the Commissioner but was a hybrid method where The Tax Court multiplied what it found to be the estimated percentage of completion of each contract by the actual ultimate net profit on each contract (R. 96, 101).

The differences between the Commissioner's method and The Tax Court's method were called to the attention of the Court of Appeals, but the Court of Appeals stated that no change in method was made by The Tax Court, the only changes being in the percentages of completion of the several projects. It is apparent, however, that The Tax

Court did more than merely change percentage of completion. In place of the completed contract method adopted by the Commissioner on the Gruber and Memorial Boulevard projects and in place of the percentage of completion based on estimated profits adopted by the Commissioner on the Dalhart job, The Tax Court used a method combining elements of both the percentage of completion method and the completed contract method, in that it multiplied the estimated percentage of completion (computed on the percentage of completion method) by the final actual net profit (computed on the completed contract method). Admittedly, The Tax Court might have revised either the estimates of completion or the estimated profit (and costs) but in abandoning the procedure of estimating job costs to arrive at estimated profit, it adopted a completely different method.

Section 41 provides that a taxpayer's method of accounting shall be used for tax purposes unless such method does not clearly reflect income, in which case the Commissioner may prescribe another method. Only the Commissioner is given such power to substitute accounting method —The Tax Court does not have such power. The Tax Court must either accept the Commissioner's method or else it must reject it, in which case the taxpayer's method must be used. The decision of the Court of Appeals in approving the method of accounting substituted by The Tax Court for the Commissioner's proposed method is directly opposed to and in conflict with the opinion of the Court of Appeals for the First Circuit in the case of *Ross* v. *Commissioner,* 169 F. (2d) 483 (1948), wherein Circuit Justice FRANKFURTER stated that Section 41 grants power to the Commissioner alone, and that nowhere in the Code or Regulations is authority given The Tax Court to sub-

stitute its judgment of proper accounting for that of the Commissioner. This Court should grant *certiorari* in order that it may not only resolve this conflict between circuits, but also decide whether Section 41 permits The Tax Court to assert the power therein granted the Commissioner of Internal Revenue.

8.

Section 41 does not permit the use of an accounting method which includes in income amounts which as a matter of law do not constitute income within the taxable period involved.

While orderly development of the case requires that this point appear late in petitioners' argument, its importance should not be judged by its position, for the Court of Appeals, in approving a method of accounting which takes into income amounts which, on September 20, 1942, could not then be regarded as income under any theory of accounting, committed an error which more than any other demands review in this Court.

Even though it be conceded that Oklahoma Standard was taxable on income from the contracts, and that Section 41 was properly applied by the Commissioner and The Tax Court, the method of accounting substituted, being based on the final and actual net profit from the contracts, resulted in including in Oklahoma Standard's income for the period ending September 20, 1942, amounts which on that date were but contingently earned. Included in the final net profits to which the percentages of completion were applied were amounts withheld from Oklahoma Standard at the close of September 20, 1942, as retainage and as liquidated damages. Such amounts were withheld as a guarantee against any default or defect in construction or perform-

ance, and the right to them depended upon subsequent events. It is well established that such amounts cannot be taken into income until the contract is fully and satisfactorily performed. *Commissioner* v. *Cleveland Trinidad Paving Co.*, 62 F. (2d) 85 (C. A. 6th, 1932); *Clark* v. *Woodward Construction Co.*, 179 F. (2d) 176 (C. A. 10th, 1950). Similarly, increases in contract prices by reason of contract amendments executed after September 20, 1942, are not accruable as income on that date. Furthermore, subsequent estimates, *i. e.*, amounts which were received by Delaware Standard after September 20, 1942, with respect to estimates for work done for periods of time after that date, are not accruable on that date.

These amounts were all included in the final profit on each job, a portion of which was taxed to Oklahoma Standard. None of these classes of items could come into existence as income until Delaware Standard had performed certain acts and all of those acts occurred after September 20, 1942. None of these items as a matter of law was then accruable because each was contingent and wholly dependent upon future events and on September 20, 1942, Oklahoma Standard did not have any fixed or absolute right to receive any of them. When the right to receive an amount becomes fixed, final and definite in amount, the right accrues and the amount is then includible in gross income. *Security Flour Mills Co.* v. *Commissioner*, 321 U. S. 281 (1944); *Spring City Foundry Co.* v. *Commissioner*, 292 U. S. 182 (1934).

The attention of the Court of Appeals was called to the effect of including such contingent and indefinite amounts in the income of Oklahoma Standard; but the court disposed of the argument by stating in effect that, since broad discretion is granted the Commissioner under Sec-

tion 41 and since he had proposed such method and secured its approval by The Tax Court, his selection should stand (R. 237). In permitting the taxation on September 20, 1942, of such amounts which were clearly not income on that date, the Court of Appeals not only departed from the cardinal principles of taxation as announced by this Court (*Security Flour Mills Co.* v. *Commissioner, supra; Spring City Foundry Co.* v. *Commissioner, supra; North American Oil Consolidated* v. *Burnet,* 286 U. S. 417 (1932); *Lucas* v. *American Code Co.,* 280 U. S. 445 (1930)), but also decided the case in conflict with decisions of the Courts of Appeals of other Circuits. The Court of Appeals for the Third Circuit held, in the case of *Keasbey & Mattison Co.* v. *United States,* 141 F. (2d) 163, 166 (1944) that Section 41 does not permit the Commissioner to add to income items which as a matter of law are not accruable. In *Clifton Mfg. Co.* v. *Commissioner,* 137 F. (2d) 290, 293 (1943), the Court of Appeals for the Fourth Circuit held that Section 41 does not empower the Commissioner to add to income in one year items which rightfully belong and are accruable in another year. The same rule was announced by the Court of Appeals for the Eighth Circuit in the case of *Commissioner* v. *Mnookin's Estate,* 184 F. (2d) 89, 93 (1950). Such conflict among the Circuits should be resolved by this Court.

9.

Oklahoma Standard is entitled to a net operating loss deduction under Sections 23(s) and 122 of the Internal Revenue Code, representing the carryback to 1942 of the net operating loss of Delaware Standard for the period ending September 30, 1943.

Delaware Standard in its corporation income and declared value excess-profits tax return for the fiscal year

ended September 30, 1943, reported net income of $29,528.50. (R. 80) Included therein was $155,488.34 of net income from the Gruber joint venture (R. 80) and $117,783.97 of net income from the Dalhart joint venture. (R. 82)[2] If it be held that Oklahoma Standard realized income at the close of September 20, 1942, from the Dalhart and Gruber joint ventures, the result will be to shift such income from the aforesaid return of Delaware Standard to the return of Oklahoma Standard for the period ending September 20, 1942. In such event, Delaware Standard had an operating loss for the period ending September 30, 1943.

It is the position of the petitioners that, since the reorganization of Oklahoma Standard was tax-free, this operating loss of Delaware Standard must be carried back through the re-organization to the return of Oklahoma Standard for the period ending September 20, 1942, and that Oklahoma Standard thereby is entitled to a net operating loss deduction under Sections 23(s) and 122 of the Internal Revenue Code for that period. The decision of the Court of Appeals to the contrary renders ineffective the underlying purpose of the tax-free reorganization sections and calls for consideration by this Court. Furthermore, the decision creates a conflict between the Circuits which should be resolved, for the Court of Appeals for the Second Circuit, in the case of *Stanton Brewery* v. *Commissioner*, 176 F. (2d) 573 (1949), held that where there was a statutory merger, an unused excess profits credit of a component corporation could be carried over.

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2. These items of $155,483.34 and $117,783.97 were largely offset by various deductions authorized by law so that the total net income of Delaware Standard for the period was $29,528.50.

Conclusion.

Section 41 of the Internal Revenue Code vests considerable discretion in the Commissioner of Internal Revenue, and, without clear definition of when and how his powers thereunder may be exercised, it may be utilized by him as an implement whereby recognized principles of income taxation and other provisions of the Code may be disregarded and atrophied. This case presents several questions as to the extent and the manner of exercise of such power of the Commissioner in acting under Section 41, and it is therefore respectfully submitted that the case is one calling for review by this Court by granting a writ of *certiorari.*

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